What's It Worth?

What You Need To Know About Business Valuation

By Mark McNally, CPA, CVA

SO, JUST HOW MUCH IS YOUR RESTAURANT WORTH?

As a restaurant owner, you may need to know at some point the value of your business, whether to evaluate goals, set compensation levels, develop a succession plan or sell it to someone outside the family.

Whatever the reason, one thing is for certain. The stock price of your privately held company is not readily determinable. The valuation process begins by identifying the purpose for which the valuation is being performed and then engaging an experience valuation consultant who understands that purpose.

Most businesses are sold on their ability to generate cash flow. So you must ask yourself, what expenses do we have that are not affecting cash flow, for example, depreciation? A company that has apparently good earnings may have showing as profit what it should have been investing in maintenance, major repairs or upgrading of equipment, therefore making it look better on paper.

Based on the consistent application of sound methodology theory, a valuation report should sustain scrutiny by a potential buyer as well as other third parties, including financial institutions.

Appraisers address a number of factors, including the book value of the stock and company's financial condition.

To value a closely held business, the appraiser will assess the financial, operational and economic attributes of that business. Their experience and judgment help them evaluate the company's true earning capacity, which bears directly on the company's value.

Appraisers address a number of factors when determining the value of a business. They include:

- the nature of the business and its history;
- the economic outlook;
- the book value of the stock and company's financial condition;
- dividend-paying capacity;
- sales of the stock and size of the block of stock to be valued;
- market price analysis of stock in similar lines of business; and
- whether the enterprise has goodwill or other intangible value.

The key is to identify drivers that create or detract from the value of that business. Every industry has its own rules of thumb to help determine a sales price. Use this information as a reality check when your appraiser sets the price of yours.

Current Sales Prices

What is your business worth? Here are some facts we've interpreted from our database that tracks food industry sales.

- Restaurants with cocktails sold for an average of 79 percent of the asking price; this represents 25 percent of the gross annual sales;
- Family restaurants sold for an average of 75 percent of asking price, or 30 percent of gross annual sales;
- Restaurants serving breakfast and lunch, 71 percent of asking price, or 33 percent of gross annual sales;
- Coffee shops sold for an average of 85 percent of asking price, or 49 percent of gross annual sales;
- Fast food takeout restaurants, 94 percent of asking price, or 37 percent of gross annual sales.

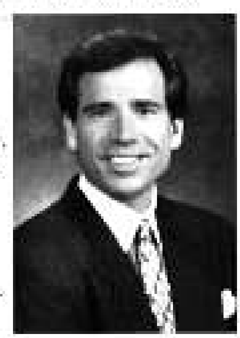
It is important to note that the price someone pays for a business may be something other than fair market value. Often, the price a buyer will pay for a privately held company depends on the risk he will be taking and his required rate of return. **WR**

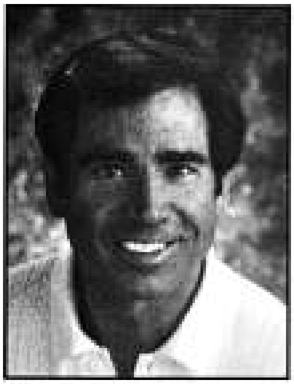
Mark F. McNally, CPA, CVA serves as an advisor to family-owned businesses and their employees. He is the president of McNally CPAs & Restaurant Consultants, S.C. in Madison. His radio program, "Mark McNally's The Family Enterprise," can be heard each Sunday from 8 to 10 a.m. on Newsradio 1310 WIBA in Madison. He can be reached at 277-1200.

Don't Miss Mark McNally's Seminar at Host Midwest!

"Finding Your Financial Future"
Wednesday, March 31
10:30 a.m.-noon

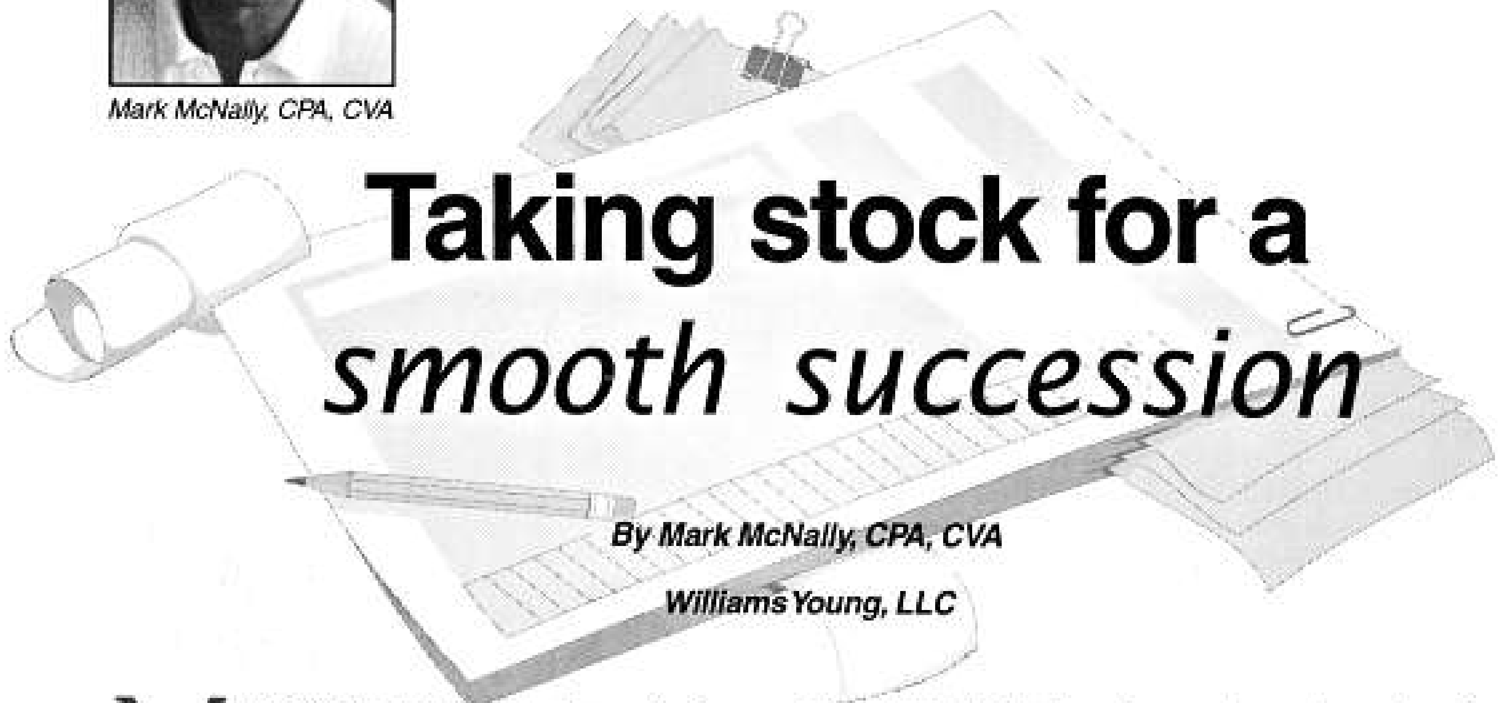
Lack of planning can mean financial disaster when it comes time to sell your business or pass it on to your heirs. In this crucial seminar, a panel of business finance experts offer solutions for business succession planning.





Mark McNally, CPA, CVA

The time to shape and perfect a succession plan and prepare your successor is when things are going smoothly, not during a crisis, and long before the owner is ready to retire.



Taking stock for a *smooth succession*

By Mark McNally, CPA, CVA

Williams Young, LLC

Many family business founders dream of a legacy in having their enterprise prosper long after their retirement or death. With an innate desire to create something that lasts beyond their lifetime, some business owners hope their children will carry on the family tradition.

In reality, that may be quite a feat, especially in an environment where 70 percent of all family businesses are either liquidated or sold before making it to the second generation. A lack of planning can be even more devastating to family businesses if the owner dies unexpectedly or becomes disabled without a succession plan in place.

By developing a well-thought out succession plan, you will ensure that your business will remain healthy when you leave the business and your family will avoid the conflicts associated with a lack of succession planning. A soundly designed succession plan should also result in a smooth transition and allow the owner to maximize the business's value for greater income potential at transition.

The time to shape and perfect a succession plan and prepare your successor is when things are going smoothly, not during a crisis, and long before the owner is ready to retire. Keep in mind that it often takes two or three years to develop a plan, resolve contingencies and make a successful transition.

This article will focus on the emotional and technical considerations that should go into the succession planning process.

Communication is key

Communication is critical in developing a succession plan. Discuss your wish to develop such a plan with those closest to your business. Let them know your desires for the future of your company. Keep in mind however, that some advisors may want to maintain the status quo. They may not provide the level of octane needed to move a succession plan forward. What you'll need is a trained and experienced outside person to help you develop the plan, someone who is experienced in dealing with family businesses and understands the emotional landscape that goes along with the succession planning process.

What we have seen repeatedly has allowed us to put together a comprehensive program called "Companies @ the Crossroads." One aspect of this program helps us guide family business owners during the development of a succession plan.

First of all, gather information. The business owner and spouse need to talk about the direction of the family business as well as their expectations regarding fair vs. equitable treatment of the children. Include children, key employees and members of the board of directors/advisors in further discussions, and use confidential questionnaires to gain even more critical and objective information from these sources. The direction of the business's future becomes even more obvious after this information is filtered and evaluated.

Once you've identified the successor, their skills will need to be nurtured to ensure leadership and consensus. Mentoring and coaching should be provided. The business owner may also need to be coached. Letting go will no doubt be difficult and the owner needs to be prepared to enter the next phase of life. But, the business owner should plan on staying with the business for a reasonable time to ensure a smooth transition. Staying involved will allow the founder to monitor the business and its profitability closely. This is especially critical if seller financing is involved.

Perhaps a successor will be found within the family tree or current management lineup. Another possibility could be to sell the business to employees or to someone outside the company. Only after the successor has been picked should the following technical aspects be considered.

Technical aspects

Every succession plan should include tax and estate planning strategies to minimize the unexpected, devastating financial impact of an owner's premature death or disability. The following are some of the more commonly used tools in succession planning:

1. Buy-sell agreements: Buy-sell agreements dictate what will happen to the business in the event of an owner's death, disability, retirement or desire to sell or transfer ownership before retirement. Be careful. Too often, business owners use "canned" buy-sell agreements that don't consider the individual circumstances of the owners involved. The most common types of buy/sell agreements include redemption agreements, cross-purchase agreements, hybrid agreements, and third-party buyout agreements.
2. Insurance: Insurance can be used in a number of ways in succession planning. The most common method of funding buy-sell purchase obligations is with insurance. Also consider key-man life insurance coverage, which funds the amount needed to pay the salary of a comparable individual after the death of the owner to keep the business going. Insurance may also be used to fund estate taxes at the time of death.
3. Family limited partnership: The family limited partnership (FLP) is a popular tool that allows business owners to minimize estate and gift taxes (by transferring minority limited partnership interests to family members) while retaining control of the business. In addition to helping family business owners achieve a number of strategic business objectives, the FLP also allows for the shifting of income and future appreciation to children or grandchildren in a lower tax bracket.
4. Trusts: Like insurance, trusts can be used in many ways during the succession planning process. Trusts are used to preserve wealth, minimize estate taxes, make assets available to heirs and pay obligations once they become due.
5. ESOP/LBO: An Employee Stock Ownership Plan (ESOP) provides business owners with a vehicle for selling the company, diversifying their investments or raising capital, in many cases on a tax-deferred basis. For a leveraged buy-out (LBO), the employee group almost certainly must borrow part of the purchase price.
6. Employment contract for key non-family members: Retaining key employees during times of transition is vital to a business's success. Such a contract can provide to the key employee a measure of security during a succession and provide details of future compensation. From the employer's perspective, an employment contract may provide protection in the form of non-compete and non-disclosure clauses.
7. Deferred compensation agreements: Deferred compensation agreements can provide long-term incentives and help key employees supplement their retirement income.

As demonstrated here, there is a myriad of options available to the business owner interested in succession planning. An experienced advisor can help you develop a systematic approach to setting goals, work through conflicts of interest and sort through the vast array of sophisticated planning tools available. Be sure to contact your legal counsel and your CPA for specific guidance to your situation.

Mark F. McNally, CPA, CVA serves as an advisor to family-owned businesses and their employees. He is the director of the Family Business Group at Williams Young, LLC, in Madison. His radio program, "Mark McNally's The Family Enterprise," can be heard each Sunday from 8 to 10 a.m. on Newsradio 1310 WIBA. He can be reached by phone at (608) 274-1980 or by email at info@williamsyoung.com.

Editor's note: see related story page 21.

business as well as their expectations regarding fair vs. equitable treatment of the children. Include children, key employees and members of the board of directors/advisors in further discussions, and use confidential questionnaires to gain even more critical and objective information from these sources. The direction of the business's future becomes even more obvious after this information is filtered and evaluated.

Once you've identified the successor, their skills will need to be nurtured to ensure leadership and consensus. Mentoring and coaching should be provided. The business owner may also need to be coached. Letting go will no doubt be difficult and the owner needs to be prepared to enter the next phase of life. But, the business owner should plan on staying with the business for a reasonable time to ensure a smooth transition. Staying involved will allow the founder to monitor the business and its profitability closely. This is especially critical if seller financing is involved.

Perhaps a successor will be found within the family tree or current management lineup. Another possibility could be to sell the business to employees or to someone outside the company. Only after the successor has been picked should the following technical aspects be considered.

Technical aspects

Every succession plan should include tax and estate planning strategies to minimize the unexpected, devastating financial impact of an owner's premature death or disability. The following are some of the more commonly used tools in succession planning:

1. **Buy-sell agreements:** Buy-sell agreements dictate what will happen to the business in the event of an owner's death, disability, retirement or desire to sell or transfer ownership before retirement. Be careful. Too often, business owners use "canned" buy-sell agreements that don't consider the individual circumstances of the owners involved. The most common types of buy/sell agreements include redemption agreements, cross-purchase agreements, hybrid agreements, and third-party buyout agreements.
2. **Insurance:** Insurance can be used in a number of ways in succession planning. The most common method of funding buy-sell purchase obligations is with insurance. Also consider key-man life insurance coverage, which funds the amount needed to pay the salary of a comparable individual after the death of the owner to keep the business going. Insurance may also be used to fund estate taxes at the time of death.
3. **Family limited partnership:** The family limited partnership (FLP) is a popular tool that allows business owners to minimize estate and gift taxes (by transferring minority limited partnership interests to family members) while retaining control of the business. In addition to helping family business owners achieve a number of strategic business objectives, the FLP also allows for the shifting of income and future appreciation to children or grandchildren in a lower tax bracket.
4. **Trusts:** Like insurance, trusts can be used in many ways during the succession planning process. Trusts are used to preserve wealth, minimize estate taxes, make assets available to heirs and pay obligations once they become due.
5. **ESOP/LBO:** An Employee Stock Ownership Plan (ESOP) provides business owners with a vehicle for selling the company, diversifying their investments or raising capital, in many cases on a tax-deferred basis. For a leveraged buy-out (LBO), the employee group almost certainly must borrow part of the purchase price.
6. **Employment contract for key non-family members:** Retaining key employees during times of transition is vital to a business's success. Such a contract can provide to the key employee a measure of security during a succession and provide details of future compensation. From the employer's perspective, an employment contract may provide protection in the form of non-compete and non-disclosure clauses.
7. **Deferred compensation agreements:** Deferred compensation agreements can provide long-term incentives and help key employees supplement their retirement income.

As demonstrated here, there is a myriad of options available to the business owner interested in succession planning. An experienced advisor can help you develop a systematic approach to setting goals, work through conflicts of interest and sort through the vast array of sophisticated planning tools available. Be sure to contact your legal counsel and your CPA for specific guidance to your situation.

Mark F. McNally, CPA, CVA serves as an advisor to family-owned businesses and their employees. He is the director of the Family Business Group at Williams Young, LLC, in Madison. His radio program, "Mark McNally's The Family Enterprise," can be heard each Sunday from 8 to 10 a.m. on Newsradio 1310 WIBA. He can be reached by phone at (608) 274-1980 or by email at info@williamsyoung.com.

Editor's note: see related story page 21.